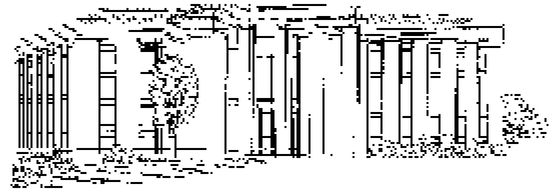
KTRS NEWSLETTER

TEACHERS' RETIREMENT SYSTEM
OF THE STATE OF KENTUCKY

RETIRED MEMBER EDITION
January/February 2006



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2006 General Assembly

Important Information About The Budget and Your KTRS Retirement and Medical Benefits

(An Executive Summary of this article is included on page 4 of this newsletter)

Like all Kentucky citizens, members of the Kentucky Teachers' Retirement System should be concerned about the financial status of the Commonwealth during the upcoming biennium. The Governor's recommended budget for the next two fiscal years certainly reflects that State Government will not have the income to meet all the demands placed upon it.

While we understand the seriousness of the financial problems facing the Governor and members of the 2006 General Assembly, we do not feel that they would choose to do anything to jeopardize either the financial soundness of the Teachers' Retirement System or the medical benefit for retired teachers. ***Unfortunately, in an effort to balance a very difficult General Fund Budget for the next two years, $42 million cited by the System's independent actuary as needed to properly fund the System was not allocated.*** In addition, because more than 20% of active KTRS members are eligible to retire, the System's actuary safely and conservatively estimated that $269 million would be needed for retiree medical benefits for the next biennium. The administration chose to consider historic rates of retirement and reduced the actuarially estimated amount needed for the cost of retiree medical benefits to $233 million. Of this reduced estimated amount, only $9 million of the $233 million was actually funded in the budget. The remaining balance of $225 million is provided for in the budget through borrowing from funds otherwise specifically designated by statute to be deposited into the KTRS Pension Plan. The Governor's Budget does contain funding of $14 million in the second year of the biennium to start amortizing $97 million of the $225 million in funds borrowed.

This practice of borrowing from the Pension Plan presents a very serious problem for long-term funding of both the retirement benefit and the medical benefit for retired teachers. The Governor stated in his Budget Address, "My budget proposal maintains the health insurance program for retirees, but necessarily relies on financing mechanisms that have been used in the past, but that are unsustainable in the long run. We must address this issue over time." The Governor's words are directly on point. This financing mechanism, used for the first time in the last biennium, does not provide for such unsustainable withdrawals from the Pension Plan for purposes beyond providing for retirement benefits.

KTRS was formed by statute in 1938 to provide retirement benefits for teachers that, as a group, were excluded from participating in the newly formed Social Security program started in this country in 1935. Fortunately for Kentucky

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educators, KTRS was designed by law to be an actuarially sound "retirement reserve" program to provide a reasonable level of retirement income to Kentucky's public school teachers. This means that throughout a teacher's career, the teacher would contribute to the plan and the state would match those contributions, and those combined funds would be invested to provide the promised benefit upon retirement. This System has worked well for over 65 years and the current issues must be properly addressed for the System to continue adequately serving the members.

To ensure the funding is sufficient to meet those obligations, state law provides that KTRS employ a competent actuary to annually evaluate the costs of benefits that have been earned by teachers and the levels of contribution that the System must receive in order to maintain reserve funds with which to pay those promised benefits. To this end, the System contracts with an independent, national actuarial firm with vast experience in public pension plans to annually review the funding for retirement and medical benefits. These reports are forwarded to the Governor and the General Assembly annually, where the decision is made regarding the amount of contribution that active members and the state must make to both maintain the operation of the System on an actuarially and financially sound basis and to provide retiree health care benefits.

The retirement benefit is pre-funded with monies set aside and invested to guarantee the benefit. However, by statute, the medical benefit for retired teachers is a pay-as-you-go benefit, meaning simply that the funds will be made available annually as the premiums are paid. The medical benefit was created in 1964 and is funded through a contribution from active teachers of 3/4ths of 1% (0.75%) of teacher salaries. This contribution is matched by the state. Though initially sufficient to cover the total cost of the medical benefit, the combined contributions are now sufficient to cover only a portion of the cost. As medical costs continue to rise much faster than teacher pay and the consumer price index, and with the ratio of active contributing members, as compared with retired members, decreasing as the System matures, this combined funding is supporting a diminishing percentage of the medical benefit.

To supplement the declining funding, statutes were amended in 1998 to permit part of the employer contribution to the Pension Plan (up to 3.25%) to be used to fund the medical benefit. The portion of the 3.25% employer contribution to the Pension Plan, available to apply to the medical benefit, is determined annually by the System's independent actuary. From 1998 through 2005 this percentage amount varied from a peak of 3.25% in fiscal 2001 and fiscal 2002 to the lowest level of 1.02% in fiscal 2005. During this seven year period, $336 million in employer contributions was re-directed to help provide retiree medical benefits. The largest amount in any one fiscal year was $76 million in 2002. Beginning in fiscal 2006, the actuary determined that all of this funding would be needed to apply to the unfunded obligations of the Pension Plan, and the KTRS Board of Trustees requested that the $336 million be returned to the Pension Plan with interest over the next ten years. The Governor's budget for this biennium did not address the Board's request that this funding be returned.

Benefits that continue to be substantially underfunded will become a progressively larger burden on state government and taxpayers. The requirement to meet an increasingly larger liability may well collide with other demands on the state's resources, and could result in a decline in retiree medical benefits. In order to provide a more stable source of funding for the medical benefit, the Board of Trustees sought a law change that would stabilize the funding necessary to continue this pay-as-you-go benefit. During the 2004 Regular Session of the General Assembly, KRS 161.550(2) was amended to direct the state to begin funding this benefit. This law passed both the House and Senate with no dissenting votes and was signed into law by the Governor, indicating the clear intent of both the Legislature and Governor to fund retiree health care. The issue now is for them to follow through with this intent and provide the needed funding without reducing assets necessary to fund future retirement benefits.

The cost of medical insurance provided through the Kentucky Employees Health Plan for public employees and public employee retirees under age 65 increased much more in 2005 and 2006 than could reasonably be expected in the spring of 2004 when the medical stabilization amendment was composed and ratified. Monthly insurance costs increased by 70% during the two year period of 2004 to 2006. The retiree cost increased from $286 per month in 2004 to $410 per month in

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2005 (43% increase) and from $410 per month in 2005 to $489 per month in 2006 (19% increase). Consequently, the need for additional funding for medical insurance was accelerated two years sooner than originally anticipated. Additional funding was secured utilizing the existing statute that allowed up to 3.25% of employer retirement contributions to be re-directed to fund retiree medical benefits. This funding, unlike the funding from 1998-2004, was based upon the promise it would be repaid with interest over a ten year period. The total amount transferred to continue the benefit for the two-year period and to be repaid was $91 million. The Governor's budget for the biennium contains the amounts necessary for amortized payments ($13 million each year of the biennium). At the end of fiscal 2005, the medical benefit had a fund balance of $145 million. This amount is adequate to meet the Board of Trustees' goal of maintaining a fund balance sufficient to provide 6 months of medical benefits for retirees.

The June 30, 2005 Actuarial Valuation of the Teachers' Retirement System retirement benefit reflects that the System had an unfunded obligation of $4.5 billion. While this is a large amount, the actuary stated that the System is operating on an actuarially sound basis. The actuarial assumptions assume that contributions to the System are made by the employee and the employer from year-to-year in the future at the rates recommended on the basis of successive actuarial valuations. Under this assumption, the continued sufficiency of the Pension Plan to provide retirement benefits may be safely anticipated. Nearly all public retirement plans have unfunded liabilities that do not present immediate problems if the state has taken sufficient measures to discharge the obligation within a thirty year period. The actuary reports that the employer contribution ***needs to increase by $42 million*** over the upcoming biennium. ***By increasing the employer contribution rate .11% ($3 million) in the first year of the biennium and 1.32% ($39 million) in the second year of the biennium, the System would be able to amortize its unfunded obligation over the next thirty years.*** As reported earlier, the Governor's budget did not include this needed funding.

The value of the System's assets exceeds $14 billion and there is no present difficulty in meeting the current retirement payroll which exceeds $1 billion per year. The concern of the System is that adequate funding be provided to assure payments for future retirement and medical benefits for retired members and those active members that have already earned their right to receive benefits. The Board's Actuary has stated that the contribution to the System needs to be increased as indicated above. The Board of Trustees has complete confidence in recommendations of the independent actuary, and has urged members of the 2006 General Assembly to adequately fund both the retirement plan and the medical benefit.

For many years, KTRS has had numerous meetings with legislators, legislative committees, the Governor's Budget Office, and others in efforts to maintain medical benefits for retirees and to continue funding the Pension Plan in a sound manner. This activity will continue, not only during this legislative session, but afterwards, as the System seeks funding to continue operating its retirement benefit program in an actuarially sound manner and seeks funding that would meet the immediate and long-term needs of the medical benefit program.

Cost of Living Increases (COLAs)

The Teachers' Retirement System requested funding needed to provide a COLA that would keep pace with the projected cost of living reflected in the Consumer Price Index as established by the Congressional Budget Office. A base COLA of 1.5% is provided in the planned funding of the retirement system, so additional funding must be secured to provide the added amount needed to have the benefit keep pace with inflation. An added COLA of 2.1% in the first year and 1% in the second year was requested. The Governor's budget contained funding targeted to improve benefits, but not to the level sufficient to provide the requested COLAs.

Executive Summary of Funding Provided in Governor's Budget

By statute, retirees' pensions are paid from the Pension Plan, an actuarial reserve fund that is pre-funded during a teacher's career. The medical benefit for retired teachers is provided by statute on a pay-as-you go basis after a teacher retires, with the state responsible for providing additional funding to pay the benefit beyond the base funding of the benefit from employee and employer match. The Administration's budget is short of providing funding requested by the KTRS Board of Trustees for both the Pension Plan and for retiree medical benefits with one of the four priority areas being fully funded. Below is a schedule of funding requested in these four areas and the related funding provided in the Governor's budget.

	KTRS Board's Request		Governor's Budget	
	FY 07	FY 08	FY 07	FY 08
Funding for Amortization of Prior Benefits	$ 130,428,400	$ 132,158,400	$ 130,428,400	$ 132,158,400
Increase in Employer Funding of the Pension	$ 3,174,600	$ 39,243,600		
Funding for Medical Benefits	$ 114,862,800	$ 154,001,400	$ 8,793,000	$ 14,133,200
Funding for Retiree Medical Benefits Borrowed from KTRS Pension Plan			*$ 105,804,500*	*$ 127,394,000*
Funding for Retiree COLA	$ 22,454,600	$ 33,872,200	$ 4,312,800	$ 7,865,100

¨ **Funding for Amortization of Prior Benefits**

The funding for prior benefits, such as retiree COLAs, were included in the Governor's Budget as requested by KTRS.

¨ **Increase in Employer Funding of the Pension Plan**

Unfortunately, in an effort to balance a very difficult General Fund Budget for the next two years, $42 million cited by the System's independent actuary as needed to properly fund the System was not allocated. ***Proper funding of the pension benefit is extremely important to our members,*** and KTRS makes every effort to inform the General Assembly of the importance of properly funding the Pension Plan.

¨ **Funding for Retiree Medical Benefits**

Funding for retiree medical benefits is provided in the Governor's Budget by borrowing funding that would otherwise be specifically designated by statute to be deposited in the KTRS Pension Plan. Though the Governor's Budget provides a means of funding this benefit for the next two years, borrowing from the Pension Plan presents concerns for long-term funding of both the retirement benefit and the medical benefit for retired teachers, and could lead to future reductions in medical benefits for retired teachers beyond this biennium. KTRS is actively working with the General Assembly to address these concerns, however, in an effort to reach a bi-partisan solution that will maintain the actuarial soundness of the retirement benefit fund on a long-term basis while meeting the funding needs of the medical insurance program for the coming biennium.

¨ **Cost of Living Increases (COLAs)**

The Governor's budget contains some funding to increase retirement allowances, but is less than the amount needed to provide the COLAs as requested by the Board of Trustees for all retirees.

For many years KTRS has had numerous meetings with the Governor's Budget Office, legislators, legislative committees and others in efforts to maintain medical benefits for retirees and to continue funding the pension plan in a sound manner. This activity will continue, not only during this legislative session, but afterwards, as the System seeks funding to continue operating its retirement benefit program in an actuarially sound manner and seeks funding that would meet the immediate and long-term needs of the medical benefit program.

Other Legislative Matters

KTRS is asking the General Assembly in this session to increase the annual disability income limitation for disability annuitants who were first retired on disability prior to July 1, 2002, from $27,000 to $40,000. If approved by the Legislature, this amendment will allow affected retirees to cumulatively draw a disability allowance and earn outside income in a non-KTRS covered position (and not in any employment requiring similar qualifications or duties as a KTRS-covered position) in an amount at least equal to, but no more than $40,000.

As always, KTRS will continue to monitor new bills, opposing those that negatively affect the retirement system and supporting those that promote and protect it. KTRS will also use the Session as an opportunity to continue to educate members of the General Assembly of the value of the retirement system to Kentucky, of the necessity of maintaining its integrity by avoiding harmful legislation, and generally of the state of the retirement and medical insurance programs.

EFT Payment Dates
Dates for 2006

January 27	July 28
February 24	August 29
March 29	September 28
April 27	October 27
May 26	November 28
June 28	December 28

These dates also reflect the automatic insurance payment dates for 2006.

Retirees Age 65 and Over
Medicare Eligible Health Plan

Effective January 1, 2006, the new Medicare prescription drug program (Medicare Part D) began offering prescription drug coverage to millions of Americans who previously had no other prescription drug coverage. As prior newsletters and special mailings have informed the KTRS Medicare eligible membership, the KTRS Prescription Drug Plan ("KTRS Plan") has received actuarial certification indicating the "KTRS Plan" is greater in benefits than the standard Medicare Part D prescription drug plan. Therefore, the majority of KTRS retirees have and will find it in their best financial interest to remain in the "KTRS Plan". If you are currently enrolled in the "KTRS Plan" and have determined that it is in your best financial interest to remain in the "KTRS Plan", you do not have to do anything. However, if you enroll in a prescription drug plan through Medicare Part D, you will not be eligible to continue the "KTRS Plan". Those retirees who are covered by Medicare and Medicaid and those who meet the requirements of the new Medicare low-income drug subsidy may need to consider that enrolling in a prescription drug plan through Medicare Part D could be financially beneficial. Please contact KTRS at 1-800-618-1687 if you still have questions concerning how Medicare Part D affects you.

Retirees Under Age 65
Kentucky Employees Health Plan (KEHP)

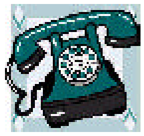
KTRS has recently learned that the 2006 Humana Summary Plan Descriptions (SPD) will not be automatically mailed to retirees as in the past. The 2006 SPD is now available on the Kentucky Personnel Cabinet's web site. It can be accessed at: http://personnel.ky.gov/stemp/dei/06planyear/default.htm.

If preferred, you may contact Humana toll free at 877-597-7474 to request the SPD be mailed to you.

2005 TAX YEAR INFORMATION

KTRS mailed 1099R tax forms during the last week of January 2006. Duplicates for lost 1099Rs may be requested by calling 800-618-1687. The information center will confirm your name and address. The tax statement contains confidential information and can only be mailed to the member's address on record. For your protection, it is necessary that the member, Power of Attorney or beneficiary mail (or Fax 502-573-0254) KTRS a written request in order to send the 1099R to a different address. This special request will not change your permanent record unless you specifically request it to be changed.

Please also visit the KTRS Web site at ktrs.ky.gov for additional information and forms, including change of address forms.



KTRS 502/848-8500
KTRS Toll Free . 800-618-1687

KERS 502-696-8800
KERS Toll Free 800-928-4646

Deferred Compensation 502-573-7925
Toll Free 800-542-2667

Revenue Cabinet 502-564-4581

IRS 800-829-1040

THE EASY EXPLANATION

BOX 1 *(less)* BOX 2a= BOX 5

BOX 1
Shows your total KTRS pension benefit prior to withholdings.

BOX 2a
Shows the taxable portion of your benefit. If blank, box 2b "Taxable Amount Not Determined" should be marked. In this case, please see your tax advisor.

BOX 5
Shows the nontaxable portion of the total. This amount is **NOT** reported anywhere on your tax return. It is an 'information only' box.

BOX 9b
This box will **only** show an amount in the first year of retirement. It provides the total amount of previously taxed contributions.

Form 1099-R 2005 OMB No. 1545-0119 Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. This information is being furnished to the Internal Revenue Service.

Payer's Federal Identification Number 61-0600439

FEDERAL *COPY B - File with Recipient's FEDERAL Tax Return*

Payer's Full Name and Address
TEACHERS' RETIREMENT SYSTEM
OF THE STATE OF Kentucky
479 Versailles Road, Frankfort, Kentucky 40601

BOX 1 **BOX 2a** **BOX 5** **BOX 9b** **BOX 10**

KY 077156

BOX 11 **BOX 12** %

BOXES 10-13
Shows the state tax information. KTRS does not withhold state taxes. Only the service earned after 1/1/98 is subject to **Kentucky** state taxes. Outside Kentucky, your resident state tax regulations apply.

Any insurance premiums paid by the member will be listed below Boxes 10-13.

KENTUCKY STATE TAX LAWS

The good news is that in preparing your Kentucky state income taxes, there is a $41,110 EXCLUSION for total state taxable pension income on the Form 740 Kentucky Income Tax Return. Your Form 740 begins with the federal adjusted gross income (AGI). Schedule M of the state return allows adjustments to the federal AGI. Schedule P of the state return is NOT always required; it reports pension income in more detail. You may want to take this newsletter to your tax preparer.

Other Considerations . . .

Your state taxable information is reported in a new format on the 1099R this year. Now you must compute the state taxable amount. Multiply the state taxable percentage (next to box 12) by the federal taxable amount in box 2a to arrive at the state taxable amount. DON'T FORGET TO APPLY THE KENTUCKY PENSION INCOME EXCLUSION AGAINST THE STATE TAXABLE AMOUNT.

Schedule M

Add all your 1099R, box 2a, *FEDERAL taxable amounts.*

IF THE TOTAL IS UNDER $41,110 YOU DO NOT HAVE TO FILL OUT SCHEDULE P. Just subtract the amount from the federal AGI by entering the amount on Part II, line 9. Therefore, you do not owe any state taxes on pensions.

IF THE TOTAL IS OVER $41,110 YOU MUST FILL OUT SCHEDULE P. Even if you are required to fill out a Schedule P, most retired teachers still do not owe any state taxes.

Schedule P

Add all your 1099R, *STATE taxable amounts. Enter the total on Part II of Schedule P.*

IF THE TOTAL IS UNDER $41,110 YOU DO NOT OWE ANY STATE INCOME TAX ON PENSIONS. Follow instructions on completing the schedule.

IF THE TOTAL IS OVER $41,110 YOU OWE STATE TAXES ON THE AMOUNT ABOVE THE EXCLUSION AMOUNT. Again, follow instructions on completing the schedule.

CAUTION:

****Computing a state taxable amount does not mean you owe state taxes!!***

****The requirement to prepare Schedule P does not mean you owe state taxes!***

Retired Prior to January 1, 1998	Retired After January 1, 1998 TOTAL FEDERAL RETIREMENT INCOME LESS THAN $41,110	Retired After January 1, 1998 TOTAL RETIREMENT INCOME MORE THAN $41,110
KTRS remains as STATE NONTAXABLE income. If you receive more than $41,110 federal taxable pension income you still must prepare Schedule P.	If total federal taxable income is less than $41,110 then all pension income is STATE NONTAXABLE income.	You must fill out Schedule P on your State Income Tax Return. Follow the instructions. Your 1099R will have the information needed to complete the Schedule P.

For Retirees Participating in the Kentucky Employees Health Plan (KEHP)

Did You Know that You Can Get a 90-Day Supply of Prescription Maintenance Drugs for Just a Two Month Copay at Your Local Pharmacy?

Express Scripts (the pharmacy benefits manager for the KEHP) is currently contacting chain pharmacies in Kentucky to see if they are interested in offering the mail order benefit at their retail locations. Any pharmacy in Kentucky may contact Express Scripts at 877-KY-SPIRIT (877-597-7575) to participate in this program.

What most think used to be a mail-order only option is now available from participating retail pharmacies. With a 90-day prescription from your physician you will receive a 90-day supply of your prescription(s) for a two month co-pay. The mail-order option is still available, but for those who would prefer to pick their prescriptions up at their pharmacy, Express Scripts has made this option available. Call your pharmacy to find out if they are participants of this program, then contact your physician for a 90-day prescription if you are interested in this option.

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TEACHERS' RETIREMENT SYSTEM
OF THE STATE OF KENTUCKY
479 Versailles Road
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2-27-06